ECON 165, Section # 4

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Plan for Today

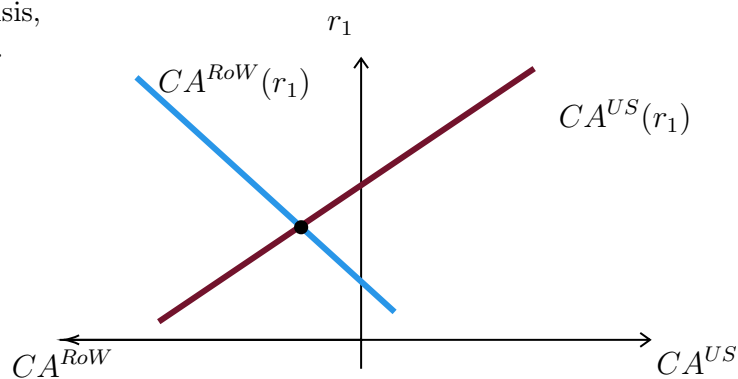
- Logistics - review section?
- US Current Account
- Practice

US Current Account

Figure: US CA as a percent of GDP.

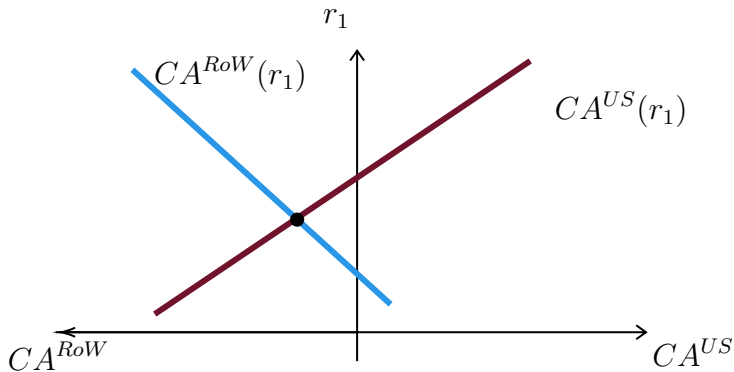
Global Savings Glut

- This theory (pushed by former Fed Chair Bernanke) says that CA movements are due to the rest of the world increasing their savings:
  - aging population implies a larger savings rate
  - Asian economies build up their precautionary savings after the Asian crisis,
  - ...



Made in the USA

- Financial innovation had resulted in low private savings and increased investment in US Savings



How to Test the Stories?

- Use a **testable prediction!**
- Each story has a prediction for what happens to the interest rate. Does it square with the data?

Practice #1

Consider a two period closed economy where capital $I_0 = 1$. The production function is given by $F(I) = \sqrt{I}$. The lifetime utility if $\ln(C_1) + \beta \ln(C_2)$. Suppose further that investment is subsidized, i.e. for every \$ that the household puts in the government puts in σ\$s ($I_1 = (1 + \sigma)B_1$).

- Am I done or do I need something else to close the model?

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- Show that the equilibrium interest rate is increasing in the subsidy σ. Why?

Solution #1

Capital Allocation Puzzle - Briefly

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→ specific story: US has seen an inflow of capital even though the theory tells us that the opposite should happen

  - step back, give me some reasons (don't worry about the CA):

Practice #2 (a)

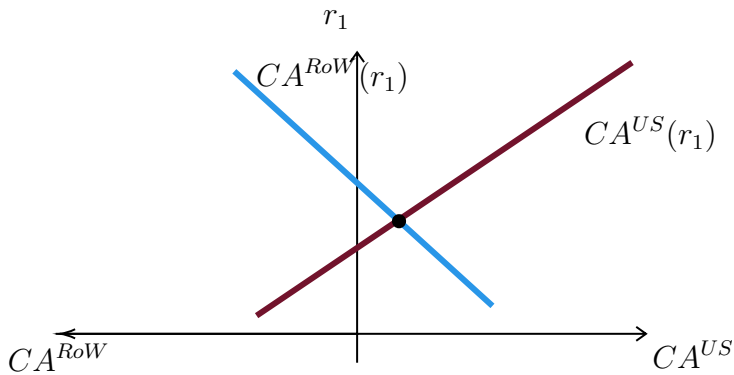
Suppose we have the US and the RoW. Suppose further that the US is an advanced economy and the RoW is developing.

- What does the Meztler diagram look like if there is no capital allocation puzzle? What if there is a capital allocation puzzle?

Practice #2 (b)

Suppose we have the US and the RoW. The RoW has a lot of corruption so there is a probability σ that the government steals the household savings and a probability $(1-\sigma)$ that the savings go to good use.

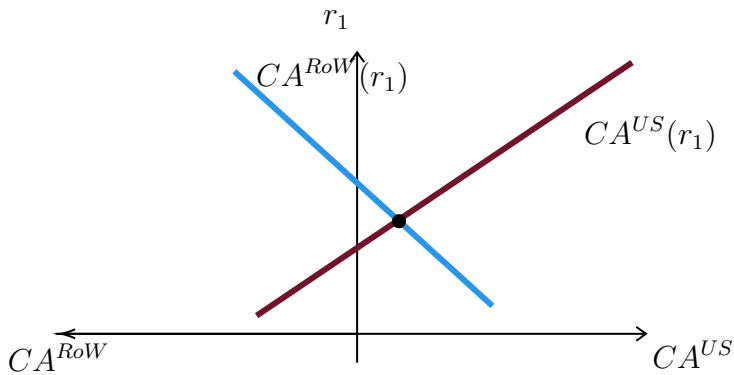
- Show in the Meztler diagram what happens when σ increases.



Practice #2 (c)

Suppose we have the US and the RoW. The RoW has a lot of corruption so there is a probability σ that the investment the firm makes is stolen by the government and a probability $(1-\sigma)$ that investment goes to good use.

- Show in the Meztler diagram what happens when σ increases.



Q&A

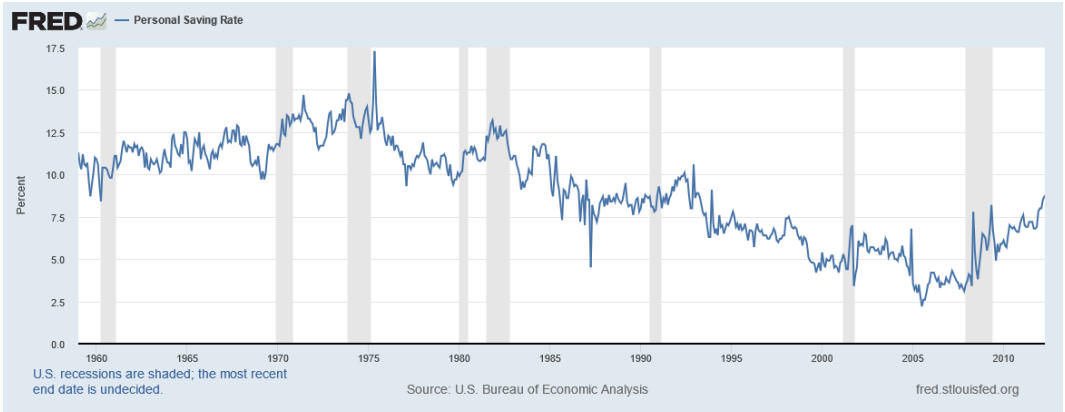


Figure: US Personal Savings Rate

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